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The Link Between Minimum Wage Hikes and Inflation

Will Clinton/Kennedy Wage Hikes Return U.S. Economy to Carter Years?

At President Clinton's and Senator Kennedy's insistence, Congress has raised the minimum wage by the largest amount ever in a two-year period, yet now union bosses' darlings are seeking to break this record by raising the minimum wage another $1.00 per hour over the next two years. Only once before have four consecutive minimum wage hikes occurred in four successive years — in January of 1978 through 1981. Those were the Carter years, an administration remembered for the combination of stagnating economic growth and rapid inflation — giving rise to the term "stagflation." The economic malaise and the attempts at market manipulation (i.e., raising the minimum wage) were not an unrelated coincidence.

The proposal of the largest-ever minimum wage increase could not come at a worse time. Inflation is always a deterrent to prosperity, and it is the most anxiously anticipated threat to the current economic expansion. The Clinton-Kennedy minimum wage hikes would have both a direct and indirect impact on inflationary pressures — just as they did during the Carter years.

- The proposed Clinton-Kennedy $1 minimum wage hike would be the largest ever over a two-year period — breaking their own two-year record of 90 cents set over the last two years.

- Only once before have there ever been four hikes in successive years — 1978-81, during the "stagflation"-era Carter years.

- Combined with the hikes of the last two years, the Clinton-Kennedy plan would result in a 45-percent increase over a four-year period, paralleling the percentage wage-hike increases of those Carter-era "stagflation" years.

Inflation's Debilitating Economic Effects

Inflation is defined as a sustained rise in prices. Literally, it is too many dollars chasing too few goods. While a period of excessive demand can cause this to happen temporarily, it cannot be long sustained because supply and demand eventually will equalize. The only way that excess dollars can exist over a sustained period is for excessive growth in the money supply itself.

The impact of inflation is devastating to an economy. It produces spiraling prices as all parties — employers and employees, buyers and sellers, and lenders and borrowers — seek desperately not only to keep up with the rapid escalation in prices, but to predict the future increases as well. It is the ultimate uncertainty and every participant in every transaction seeks to insure themselves with an "inflation premium." The economic effect of inflation is at best debilitating and at worst devastating as saving and investment are undermined by the depreciation of money's value. The result, as we discovered in the 1970s, is a misallocation of resources across the economy as parties' first concern becomes protecting themselves against inflation, not investment and saving from which real increases in wages and wealth come.

- Interest rates reached a peak of 21.5 percent for a 30-year bond on December 19, 1980.

- The effective Federal funds rate rose to its highest level since 1954, reaching 11.19 percent in 1979 and 13.36 percent in 1980 — and would continue to 16.38 in 1981.

- The economy entered a recession during the first half of 1980.

- Real GDP increased at an annual rate of just 2 percent from 1977 through 1981 (4th quarter to 4th quarter) during the period covered by the Carter minimum wage hikes. In contrast, the following four years — 1982 thru 1985, which had no minimum wage hikes — saw real GDP increase at an annual rate of 3.5 percent. And even the preceding four years — 1973 thru 1977 — saw real GDP increase at an annual rate of 2.3 percent, despite having three minimum wage increases and the OPEC oil embargo.

- In fact, this period's (1977-81) real GDP increase was lower than the 1950 through 1977 period's 3.6 percent and 1981 through 1997's 2.8 percent.

- Output per hour during this period increased at just a 0.23 percent annual rate — compared to a 1.68 percent rate from 1973 through 1977, 1.92 from 1981 through 1985, 2.42 from 1950 through 1977, and 1.26 from 1981 through 1997.

- Workers' real (as adjusted for inflation) compensation per hour actually *shrank* at a 1.11 percent annual rate from 1977 through 1981. This compares to a 1.28 percent rate from 1973 through 1977, 1.09 from 1981 through 1985, 2.40 from 1950 through 1977, and 0.58 from 1981 through 1997.

Minimum Wage Hikes and Inflationary Pressure

During this period of abysmal economic growth, Congress raised the minimum wage. Public Law 95-151, enacted on November 1, 1977, produced the first four consecutive annual minimum wage hikes in history. It also produced the largest sustained percentage increase — 46 percent — in history.

The increase in the price of any commodity — including labor — is not in itself inflationary but it does create inflationary pressure. When an increased price in a commodity can be accommodated by purchasers simply altering their purchasing patterns — purchasing less of that commodity, reducing purchases of other commodities, or both, inflation can be avoided. Yet, the economic "constriction" caused by a minimum wage hike is clearly demonstrable.

If Congress mandates it by law, wages must go up. This can be accommodated in several ways. Prices paid by consumers can go up, with the result that they will purchase less of the product in question than otherwise would have occurred. Profit margins can decline, with the result that shareholders and owners will curtail their investments below what otherwise would have occurred. In both cases, expenditures and investment will shift to other areas relatively — and in the extreme, some purchasers and operators will cease altogether. The result will be that either fewer workers or less investment will flow into the affected industries than would otherwise have occurred and that over the long-term, wages — even for those receiving the minimum wage — will actually increase less than they would have otherwise.

The same is true for the economy as a whole: Because the shift in wages is not dictated by market forces but legislative ones, the shift of resources necessary to pay a higher minimum wage forces investment from where it would have been more productively used, and the economy as a whole suffers from the misallocation of resources.

Businesses, workers, and consumers are all affected by the constriction caused by a dramatic rise in prices of a common commodity, such as labor. The rise in price cannot be accommodated without a dislocation elsewhere. It, therefore, should not come as a surprise that the market would seek to find a way around this constriction, and the simplest way is an increase in the supply of money in order to make up the difference: i.e., inflation by definition.

Through this increase in the money supply, the hard choices of reprioritizing resources can seemingly be avoided: higher minimum wages can be paid, higher prices can be passed on, consumers can pay them, and investment does not have to suffer. Yet, it is illusory, as the Carter years dramatically demonstrated: inflation is no panacea, and the minimum wage hikes were a culprit.

The Link Between Minimum Wage Hikes and Inflation

The 1978-81 minimum wage hikes coincide with America's highest post-WWII inflation.

- During 1978-81 (4th quarter 1977 through 4th quarter 1981), inflation grew at an annual rate of 10.9 percent. From 1950 through 1997, inflation grew at only a 4.1 percent annual rate. Prior to 1978-81, inflation's average annual rate of growth was 3.5 percent from 1950-77; and it was 3.5 percent from 1982-97.
- The 1978-81 period was even worse than the previous four years of seemingly high inflation from 1974 through 1977. Even though the minimum wage was increased three

times and despite the fact the fact that oil prices had begun to climb following the 1973 oil embargo, inflation still only grew at an annual rate of 7.8 percent during 1974-1977.

- From 1982-85, the minimum wage was not increased and inflation's annual rate of growth fell to 3.8 percent.

Some will argue that minimum wage increases are a response to, not the cause of, rising inflation. Interestingly however, inflation is almost twice as likely to be higher in the year following a minimum wage hike than in the year preceding one.

- Since its enactment, the minimum wage has been increased 15 times. On nine occasions, the inflation rate was higher in the year following the mandated wage hike than in the year preceding it. On just five occasions was the reverse true (and on one occasion, 1963, there was no change).

As the Joint Economic Committee points out, minimum wage increases have been associated with less robust economic performances in general:

- From 1971 to 1996, the number of jobs grew twice as quickly — 2.8 percent versus 1.4 percent — when a minimum wage had not occurred within the previous three years as when one had occurred.

- From 1971 to 1996, the economy grew at a 3.5 percent annual rate when the minimum wage had not been raised within the prior three years versus a 2.1 percent rate when it had.

The Current Threat of Inflation

The threat of inflation is constant: simply because the U.S. economy is in good shape is not a reason to discount its threat. Rather, the economy is good *because* of the absence of inflation. As Federal Reserve Board Chairman Alan Greenspan stated earlier this year:

> *"The key question going forward . . . is whether the restraint building from turmoil in Asia will be sufficient to check inflationary tendencies that might otherwise result from the strength of domestic spending and tightening labor markets."*
> [2/25/98 testimony before the Senate Banking Committee]

Since inflation was brought under control beginning in the early 1980s, the United States has enjoyed an unprecedented peacetime economic expansion. Both the longest (the period from 12/82 through 8/90) and the currently-running second-longest (3/91 and extending to present) such expansions have occurred with only a brief eight-month hiatus (from 8/90 through 3/91) during this low-inflation period. This success is not coincidental.

The disastrous consequences of government manipulation of the economy through such actions as minimum wage hikes and inflationary monetary policy were clearly demonstrated during the late 1970s. Without the pressure for an inflationary monetary policy arising from successive minimum wage hikes, the Federal Reserve has been able to pursue the low inflation policy that has produced the current economic expansions.

More government intervention directly and indirectly risks resurgent inflationary pressure. Even if the Fed were not immediately to succumb to increasing the money supply in order accommodate further minimum wage hikes, its job of safeguarding against inflation is made indirectly more difficult. The Fed must constantly scour economic indicators to detect inflation as soon as it occurs, and such oversight is made more difficult if wages are artificially increased with a minimum wage hike. As prices rise, how is the Fed to discern whether these increases are due to the artificial wage hike or real inflation? How then does the Fed react? If the Fed restricts the growth of the money supply because it incorrectly perceives inflation, it pushes a healthy economy into a deflationary straightjacket. If the Fed allows the money supply to continue to grow and inflation is present, it exacerbates an already overheating economy.

We have *not* entered a new recession-proof economic era, but we have entered a new economic mind-set, one of expectations of low inflation. Last year's increase was just 2.3 percent and 1998's annualized first quarter core rate (minus volatile food and energy prices) was just 2.4 percent. As a result, indications of what was formerly seen as mild inflation — 3 percent — or higher would seem a dangerous acceleration now and would likely prompt equally serious reactions in today's markets. Recall for example, the reaction to the recent report that the Federal Reserve has determined that it is now more biased toward tightening the money supply than loosening it: immediately thereafter, stocks momentarily plunged and interest rates climbed.

More Minimum Wage Hikes: Bad Policy, Bad Timing . . .

Minimum wage hikes are inherently bad policy: elementary economics dictate that increasing the price of a commodity means less of it will be used than otherwise would have been. And, in the case of labor, those most likely to be hurt are those least able to compete — minorities, the young, and the less-skilled. Such workers are most likely to be replaced or locked out of the job market in the first place. Finally, having the government allocate resources rather than the market means that they will not go to where they would be most productively used, and that overall, productivity — the only real engine for higher living standards — will be less than it should be.

There is never a good time for bad policy; however, one would be hard pressed to find a worse time for a minimum wage increase than present because of the inflationary pressure such increases would generate on the heels of the two recent increases. Inflation is the primary perceived threat to the current economic expansion, and to the low-inflation climate that has prevailed since 1982. Dislocating the prevailing low-inflation expectations would be particularly disruptive to our economy. This, combined with the inherent danger arising from Asia's economic problems and Europe's slow growth, could have global as well as national implications.

The risk from further minimum wage increases at this time are not just to those seeking to join the workforce and those only marginally in it, but to the American economy as a whole. While the economic gains from a minimum wage hike are illusory, the danger of inflation is real.

. . . And Bad Politics

A minimum wage hike is antithetical to economics and is not primarily concerned with increasing wages — as has been pointed out [See, RPC paper, "It's Not the Minimum Wage, It's the Maximum Taxes," 2/13/98]. An honest way to increase real pay is to reduce taxes, the growth of which has outpaced wage growth in every year of Clinton's presidency. Or, reduce federal regulations — which cost the private sector hundreds of billions of dollars that would otherwise be available for investment and wages.

The exercise of increasing the minimum wage is solely political. Why, if the wage rate should be raised, should it be raised just $1 over the next two years — why not set it at $25 per hour? Because everyone, including proponents, know that this wouldn't work. Yet the principle behind what proponents dare not propose and what they are proposing is no different, that government can set prices more efficiently than can the private sector, and that somehow, this will result in greater prosperity.

There remains just one way to truly raise wages — to raise productivity in the economy. Raising the minimum wage fails to accomplish this.

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